

# COMMODITIES AND DERIVATIVES REFORM (as of March 15, 2010)

The House of Representatives recently passed a comprehensive financial regulatory reform package. Similar legislation is currently being considered by the Senate. Taken together, the bills move the largely unregulated over-the-counter (OTC) derivatives market one step closer to being subject to a comprehensive and far-reaching regulatory regime.

	Title III (the Derivative Markets Transparency and Accountability Act of 2009) of the Wall Street Reform and Consumer Protection Act of 2009, passed by the House on December 11, 2009	Title VII (the Over-the-Counter Derivatives Markets Act of 2009) of the Senate Discussion Draft of the Restoring American Financial Stability Act of 2009, released by Senator Dodd on November 10, 2009	Title VII (the Over-the-Counter Derivatives Markets Act of 2010) of the Restoring American Financial Stability Act of 2010, released by Senator Dodd on March 15, 2010
<b>Regulatory Framework</b>	<ul style="list-style-type: none"> <li>- OTC “swaps” regulated by CFTC; OTC “security-based swaps” regulated by SEC; banking regulators retain jurisdiction over certain aspects of banks’ OTC derivatives activities (e.g., capital and margin requirements, prudential requirements)</li> <li>- “Swap” excludes, among other things, foreign exchange swaps and forwards (unless otherwise determined by the CFTC and the Treasury); sales of non-financial commodities for deferred shipment or delivery that are intended to be physically settled; any note, bond or evidence of indebtedness that is a security; and security-based swaps</li> <li>- A “security-based swap” is an agreement, contract, or transaction that would be a swap and that is primarily based on, or relates to, a single security or loan, a narrow-based security index, or a single issuer or the issuers of securities in a narrow-based security index but excludes an agreement, contract or transaction if it is based on an exempted security (other than a municipal security) and is not a put, call or other option</li> </ul>	<ul style="list-style-type: none"> <li>- OTC “swaps” regulated by CFTC; OTC “security-based swaps” regulated by SEC; Financial Institutions Regulatory Administration retains jurisdiction over certain aspects of banks’ OTC derivatives activities (e.g., capital and margin requirements, prudential requirements)</li> <li>- “Swap” excludes, among other things, foreign exchange swaps and forwards (unless otherwise determined by the CFTC and the Treasury); sales of non-financial commodities for deferred shipment or delivery that are intended to be physically settled; any note, bond or evidence of indebtedness that is a security; and security-based swaps</li> <li>- A “security-based swap” is an agreement, contract, or transaction that would be a swap and that is primarily based on, or relates to, a single security or loan, a narrow-based security index, or a single issuer or the issuers of securities in a narrow-based security index but excludes an agreement, contract or transaction if it is based on a government security</li> </ul>	<ul style="list-style-type: none"> <li>- OTC “swaps” regulated by CFTC; OTC “security-based swaps” regulated by SEC; banking regulators retain jurisdiction over certain aspects of banks’ OTC derivatives activities (e.g., capital and margin requirements, prudential requirements)</li> <li>- “Swap” excludes, among other things, foreign exchange swaps and forwards (unless otherwise determined by the CFTC and the Treasury); sales of non-financial commodities for deferred shipment or delivery that are intended to be physically settled; any note, bond or evidence of indebtedness that is a security; and security-based swaps</li> <li>- A “security-based swap” is an agreement, contract, or transaction that would be a swap and that is primarily based on, or relates to, a single security or loan, a narrow-based security index, or a single issuer or the issuers of securities in a narrow-based security index but excludes an agreement, contract or transaction if it is based on a government security</li> </ul>
<b>Clearing, Exchange Trading and Reporting</b>	<ul style="list-style-type: none"> <li>- A (security-based) swap must be cleared if a clearinghouse will accept the derivative for clearing and the CFTC (SEC) has determined (either on its own initiative or upon request by a clearinghouse) that the derivative is required to be cleared</li> <li>- Exception to the clearing requirement applies if one of the counterparties (i) is not a (security-based) swap dealer or major (security-based) swap participant, (ii) is using (security-based) swaps to hedge or mitigate commercial risk, including operating or balance sheet risk, (iii) notifies the CFTC (SEC) how it generally meets its financial obligations associated with entering into non-cleared (security-based) swaps, and (iv) elects in its sole</li> </ul>	<ul style="list-style-type: none"> <li>- A (security-based) swap must be cleared, unless the CFTC (SEC) conditionally or unconditionally exempts it from the clearing requirement, if:               <ul style="list-style-type: none"> <li>i. no clearinghouse will accept it for clearing; or</li> <li>ii. one of the counterparties to the (security-based) swap (I) is not a (security-based) swap dealer or major (security-based) swap participant and (II) does not meet the eligibility requirements of any clearinghouse that clears the (security-based) swap</li> </ul> </li> <li>- Each group, category, type or class of (security-based) swaps that a clearinghouse seeks to accept for clearing must be approved by the CFTC (SEC)</li> <li>- The CFTC and SEC must jointly adopt rules identifying</li> </ul>	<ul style="list-style-type: none"> <li>- A (security-based) swap must be cleared, unless:               <ul style="list-style-type: none"> <li>i. no clearinghouse will accept it for clearing; or</li> <li>ii. the CFTC (SEC), in consultation with the Financial Stability Oversight Council, conditionally or unconditionally exempts it from the clearing requirement if one of the counterparties to the (security-based) swap (i) is not a (security-based) swap dealer or major (security-based) swap participant and (ii) does not meet the eligibility requirements of any clearinghouse that clears the (security-based) swap</li> </ul> </li> <li>- A (security-based) swap that is exempt from the clearing requirement must be cleared upon the request of a party</li> </ul>

**Title III (the Derivative Markets Transparency and Accountability Act of 2009) of the Wall Street Reform and Consumer Protection Act of 2009, passed by the House on December 11, 2009**

- discretion for the clearing exception to apply
- Cleared (security-based) swaps must be traded on an exchange or swap execution facility, to the extent that an exchange or swap execution facility makes the (security-based) swaps available for trading
  - Non-cleared (security-based) swaps must be reported to a (security-based) swap repository or, if none, to the (SEC) CFTC

**Title VII (the Over-the-Counter Derivatives Markets Act of 2009) of the Senate Discussion Draft of the Restoring American Financial Stability Act of 2009, released by Senator Dodd on November 10, 2009**

- (security-based) swaps or any group, category, type or class of (security-based) swaps that, although not submitted for approval by a clearinghouse, should be accepted for clearing
- Cleared (security-based) swaps must be traded on an exchange or alternative swap execution facility, to the extent that an exchange or swap execution facility makes the (security-based) swap available for trading
  - Non-cleared (security-based) swaps must be reported to a (security-based) swap repository or, if none, to the (SEC) CFTC

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- to the (security-based) swap
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  - The CFTC and SEC must jointly adopt rules identifying (security-based) swaps or any group, category, type or class of (security-based) swaps that, although not submitted for approval by a clearinghouse, should be accepted for clearing
  - Cleared (security-based) swaps must be traded on an exchange or alternative swap execution facility, to the extent that an exchange or swap execution facility makes the (security-based) swap available for trading
    - Defines “alternative swap execution facility” as an electronic trading system with pre-trade and post-trade transparency in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants in the system, but that is not an exchange
  - Non-cleared (security-based) swaps must be reported to a (security-based) swap repository or, if none, to the (SEC) CFTC

**Regulation of Market Participants**

- Creates many new types of registrants: (security-based) swap dealers, major (security-based) swap participants, (security-based) swap repositories, and swap execution facilities with respect to (security-based) swaps
- A major (security-based) swap participant is any person who is not a (security-based) swap dealer and (i) maintains a substantial net position in outstanding (security-based) swaps, excluding positions held primarily for hedging, reducing or otherwise mitigating its commercial risk, or (ii) whose outstanding (security-based) swaps create substantial net counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets
- (Security-based) swap dealers and major (security-based)

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- A major (security-based) swap participant is any person who is not a (security-based) swap dealer and whose outstanding (security-based) swaps create net counterparty credit exposures (current or potential future exposures) to other market participants that would expose those other market participants to significant credit losses in the event of the person’s default
- (Security-based) swap dealers and major (security-based) swap participants are subject to capital and margin requirements, reporting and recordkeeping requirements, business conduct standards, documentation standards, and

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- (Security-based) swap dealers and major (security-based) swap participants are subject to capital and margin

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- swap participants are subject to capital and margin requirements, reporting and recordkeeping requirements, business conduct standards, documentation standards, and disclosure standards (both to counterparties and applicable regulators)
- CFTC (SEC) authorized to establish aggregate position limits and large trader reporting requirements for (security-based) swaps
- Unlawful for non-eligible contract participants (ECPs) to enter into swaps unless entered into on an exchange
- Unlawful for any person to effect a security-based swap with or for a non-ECP unless entered into on an exchange
- Offers and sales of security-based swaps to non-ECPs must be registered, absent an exemption from registration other than under section 3 or 4 of the Securities Act of 1933

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**Other**

- Jurisdictional disputes between the CFTC and SEC may be brought by either Commission for expedited review by the United States Court of Appeals for the District of Columbia Circuit
- Disputes as to certain joint rulemaking by the CFTC and SEC may be resolved, at the request of either Commission, by the Financial Services Oversight Counsel
- Increases eligibility requirements for eligible ECPs
- State and local gaming and bucket shop laws preempted in the case of security-based swaps between ECPs or traded on an exchange and swaps; additionally, security-based swaps may not be regulated as insurance under state law
- For purposes of sections 13 and 16 of the Securities Exchange Act of 1934, the purchase or sale of a security-based swap will constitute beneficial ownership of the underlying equity security only to the extent that the SEC determines, in consultation with the Treasury and applicable banking regulators, that such purchase or sale provides incidents of ownership comparable to direct ownership of the equity security and that it is necessary to achieve the purposes of section 13

- Where the CFTC and SEC fail to jointly prescribe uniform rules and regulations where required under the Act, the Agency for Financial Stability, in consultation with the CFTC and SEC, will prescribe the required rules and regulations, which will remain in effect until rescinded by the Agency for Financial Stability or until the effective date of a corresponding rule prescribed jointly by the CFTC and SEC
- Increases eligibility requirements for ECPs
- State and local gaming and bucket shop laws are preempted in the case of security-based swaps between ECPs or traded on an exchange; the current preemption in the Commodity Exchange Act remains
- Sections 13 and 16 of the Securities Exchange Act of 1934 are made applicable to security-based swaps
- At the request of a non-dealer counterparty to a non-cleared (security-based) swap, the (security-based) swap dealer must segregate the counterparty's collateral and hold it at an independent third-party custodian

- Where the CFTC and SEC fail to jointly prescribe uniform rules and regulations where required under the Act, the Financial Stability Oversight Council shall, at the request of either Commission, resolve the dispute within a reasonable time after receiving the request, after consideration of relevant information provided by each Commission, and by agreeing with one of the Commissions regarding the entirety of the matter or by determining a compromise position
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- Sections 13 and 16 of the Securities Exchange Act of 1934 are made applicable to security-based swaps
- At the request of a non-dealer counterparty to a non-cleared (security-based) swap, the (security-based) swap dealer must segregate the counterparty's collateral and hold it at an independent third-party custodian
  - Any such segregation must be made by a (security-based) swap dealer on fair and reasonable terms on a non-discriminatory basis

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